SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY

COMMENT ON THE
MARKET ADVISORY COMMITTEE
DRAFT RECOMMENDATIONS

Norman A. Pedersen, Esq.
HANNA AND MORTON LLP
444 South Flower Street, Suite 1500
Los Angeles, California 90071-2916
Telephone: (213) 430-2510
Facsimile: (213) 623-3379
E-mail: *npedersen@hanmor.com*

Attorney for the **SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY**

Dated: June 11, 2007

TABLE OF CONTENTS

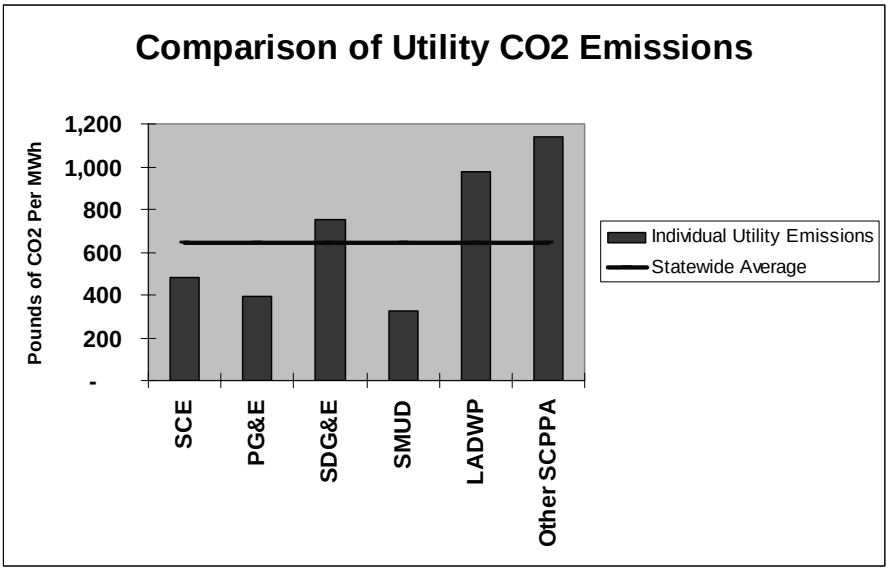
I. INTRODUCTION.

The Southern California Public Power Authority ("SCPPA") Greenhouse Gas ("GHG") Working Group[1] appreciates this opportunity to comment on the June 1, 2007 Market Advisory Committee ("MAC") Recommendations for Designing a Greenhouse Gas Cap-and-Trade System for California ("Draft Recommendations" or "DR"). SCPPA congratulates the MAC on producing a document that clearly identifies critical issues that the California Air Resources Board ("CARB") will need to address in implementing Assembly Bill ("AB") 32, the Global Warming Solutions Act of 2006.

SCPPA is pleased that although the MAC has proposed an auction as the primary means for making GHG allowances available to emitters, the MAC recognizes the need to make allowances available at no cost to regulated investor-owned utilities ("IOUs") and publicly-owned utilities ("POUs") (jointly, "LSEs"), at least on a transitional basis. However, SCPPA is concerned that the MAC has not taken the next step to recognize that the free allowances to LSEs should be allocated on the basis of historical emissions with a gradual ramp-down to meet the AB 32 goal for 2020. A failure to allocate free allowances to LSEs on the basis of historical emissions would create the potential for a massive wealth transfer of hundreds of millions of dollars annually from the southern California communities served by high carbon intensity POUs even though those communities face the greatest challenges in reducing their reliance on carboniferous resources.

Due to geographical and historical circumstances, the electricity that southern California POUs provide to their communities contains a significantly higher carbon content that than electricity provided by various other LSEs:

[1] The members of the SCPPA GHG Working Group are the Cities of Anaheim, Azusa, Banning, Burbank, Cerritos, Glendale, Pasadena, and Riverside.



Without free allowances that are allocated on the basis of historical emissions, the high carbon intensity POUs would be exposed to a substantial incremental cost of buying auctioned allowances or buying allowances being sold by others through the secondary cap-and-trade market. The cost of buying allowances would be additional to the substantial costs the POUs' southern California communities will have to bear to reduce their reliance on carboniferous resources. Requiring the high carbon intensity POUs to buy allowances without any allocation of free allowances on the basis of historical emissions would create the potential for a wealth transfer from those POUs to others, including the less challenged LSEs.

SCPPA strongly believes that an allocation of free allowances to LSEs on the basis of historical emissions with the allocation declining over time should be recognized in the MAC's final Recommendations as being a critical feature of any AB 32 implementation program.

II. GHG REDUCTION PROGRAM OBJECTIVES AND PRINCIPLES.

The DR identifies four fundamental objectives to guide the design of a cap-and-trade program to limit California GHG emissions. Given those objectives, the DR identifies ten Guiding Design Principles. The DR also sets forth eight principles to guide the distribution

of free allowances. SCPPA commends the MAC for its helpful formulations. However, SCPPA recommends some limited revisions to establish the important principle that inequitable wealth transfers should be avoided.

A. Fundamental Objectives.

The four fundamental objectives that the MAC identifies to guide the design of a cap-and-trade program are as follows:

> **Environmental integrity**—achieving specified GHG reduction targets
>
> **Cost effectiveness**—achieving emission reduction targets at low cost (where "cost" is broadly understood to include not only the compliance costs of regulated entities and costs to consumers, but also administrative and enforcement costs)
>
> **Fairness**—assuring that the program avoids causing environmental harm to particular communities, and assuring that compliance costs are spread equitably across sectors and regions
>
> **Simplicity**—offering a program that is easily communicated and administered.

DR at 18. In SCPPA's view, the third fundamental objective—fairness—dictates that compliance costs should be equitably spread across *communities* as well as sectors and regions. It would be unfair to require communities that, due to historical and geographical circumstances, face the greatest challenges and costs in meeting AB 32 goals to simultaneously transfer wealth to other communities that, due to their happier historical and geographical circumstances, are less challenged and face lower costs. SCPPA urges the MAC to revise its statement of the fundamental objective of fairness so that it reads as follows in the final MAC Recommendations to CARB:

> **Fairness**—assuring that the program avoids causing environmental harm to particular communities, and assuring that compliance costs are spread equitably across sectors, regions, *and communities*.

With that modest but important modification, SCPPA concurs with and supports the MAC's thoughtful statement of fundamental objectives. In SCPPA's view the fundamental objectives as identified by the MAC with the modification recommended by SCPPA should be guides to fashioning any AB 32 implementation program, not just a cap-and-trade program.

B. Guiding Design Principles.

The MAC applies its list of fundamental objectives to craft a set of ten Guiding Design Principles that are to be applied in designing a cap-and-trade program to limit California GHG emissions. The first principle is:

> 1. Avoid localized and disproportionate impacts on low-income and disadvantaged communities or communities already adversely impacted by air pollution.

DR at 11. SCPPA applauds this first principle and supports placing it first in the list of ten design principles. Placing it first emphasizes that equity must be paramount in designing a cap-and-trade program. However, as stated, the first principle is too narrow. While the fundamental objective of fairness requires that a cap-and-trade program should be environmentally just, fairness requires more. Communities that are more challenged or face proportionally greater costs in reducing their carbon footprint due to historical or geographic circumstances should not be required to transfer wealth to less challenged communities. Accordingly, SCPPA recommends that the first design principle be expanded to read as follows:

> 1. Avoid localized and disproportionate impacts on low-income and disadvantaged communities or communities already adversely impacted by air pollution, *and avoid wealth transfers from communities that are more challenged or face proportionally greater costs in reducing their carbon footprint due to historical or geographic circumstances.*

C. Free Allowance Distribution Principles.

The DR lists eight principles that the MAC believes should be followed in distributing some allowances for free:

- Reduces the cost of the program to consumers, especially low-income consumers
- Avoids windfall profits where such could occur
- Promotes investment in low-GHG technologies and fuels (including energy efficiency)
- Advances the state's broader environmental goals by ensuring that environmental benefits accrue to overburdened communities
- Mitigates economic dislocation caused by competition from firms in uncapped jurisdictions
- Avoids perverse incentives that discourage or penalize investments in low-GHG technologies and fuels (including energy efficiency)
- Provides transition assistance to displaced workers
- Helps to ensure market liquidity.

DR at 52. Regarding the second point about avoiding windfall profits, the MAC observes: "The free distribution of allowances can result in a substantial transfer of wealth from consumers to those entities that receive allowances." *Id.* To prevent the transfer of wealth from consumers, the MAC "recommends that California avoid windfall profits, where they would occur, by limiting the free allocation of allowances." DR at 53. "There should be no free allocation to firms under the cap that are able to pass most of their costs on to consumers." *Id.* However, there would be an exception for LSEs because "LSEs that are closely regulated or municipally owned … are likely to be obligated to pass the value of freely allocated allowances through to their ratepayers." *Id.*

Although the DR recognizes and addresses the potential for free allowances to result in a transfer of wealth from consumers, the DR does not recognize that if free allowances are allocated on an inequitable basis, the allocation of free allowances could result in a transfer of wealth from some communities to other communities. For example, if free allowances were allocated on the basis of load among LSEs rather than historical emissions, LSEs that are more dependent on carboniferous resources and that face a greater burden of meeting GHG reduction goals would paradoxically get proportionally fewer allowances than LSEs that are less dependent on carboniferous resources. The LSEs that are more dependent on carboniferous resources would face the prospect of having to buy auctioned allowances with the proceeds being distributed to, among others, the LSEs that are less dependent. The result would be a transfer of wealth that should be avoided just as much as the transfer of wealth from consumers that concerned the MAC. Accordingly, the second principle in the list of eight principles that the MAC believes should be followed in distributing allowances for free should be expanded to read as follows:

- Avoids windfall profits *or transfers of wealth among communities* where such could occur.

III. AS A RESULT OF HISTORICAL AND GEOGRAPHICAL CIRCUMSTANCES, SCPPA AND ITS MEMBERS ARE SADDLED WITH A RESOURCE MIX THAT IS SUBSTANTIALLY CARBON BASED.

SCPPA is a joint powers authority ("JPA") that was formed in 1980. Twelve POUs are members of SCPPA.[2] Those POUs, in aggregate, currently serve two million customer meters and a population of 4.6 million people. The SCPPA members own or control 9,000 megawatts ("MW") of electric generation capacity.

[2] Anaheim, Azusa, Banning, Burbank, Cerritos, Colton, Glendale, Los Angeles Department of Water and Power, Imperial Irrigation District, Pasadena, Riverside, and Vernon.

SCPPA and its members are unequivocally committed to achieving AB 32 GHG reduction goals. However, as a result of geographical and historical circumstances, SCPPA and its members are encumbered by electrical generation resources that are carbon based. Currently, 76 percent of SCPPA member resources are carbon based: 47 percent coal and 29 percent gas. Renewable resources are six percent of the resource mix, nuclear is nine percent, hydro is five percent, and unassigned purchases are four percent.

Reliance by SCPPA members on coal resources, primarily the Intermountain Power Project in Utah and the San Juan Project in New Mexico, is a legacy of the 1970s. In 1976, Congress adopted the Fuel Use Act. The Act precluded development of new gas-fired resources. As for hydro-electric resources, although southern California is blessed with a benign climate, spectacular scenery, and an enviable lifestyle, the region is generally arid. That precludes major new hydroelectric generation in the region. When confronted by the need to add substantial capacity that could produce electricity for southern California's burgeoning population while containing costs, SCPPA and its members resorted to coal-fired facilities located in nearby western states. The addition of the coal-based resources was driven by a combination of legal, geographical, and economic circumstances. The global warming consequences of such resources were not understood at the time.

Today, there is common awareness of the need for a dramatic change in resources. The SCPPA members are committed to making that change, as evidenced by their efforts to promote energy efficiency and to add renewable resources. However, the shift from carbon-based generation to non-carbon resources is going to take time and is going to be costly.

IV. THE COST OF MEETING GHG REDUCTION GOALS IS LIKELY TO BE HIGH FOR SCPPA MEMBERS.

Although SCPPA and its members are fully committed to achieving GHG emission reduction goals, the cost is likely to be high, given their proportionally higher reliance on carboniferous resources.

A. Energy Efficiency and Demand Reduction Costs.

The SCPPA members have already spent nearly $800 million from 1997 through 2006 on public benefits programs, with the highest percentage (34 percent or $262 million) being spent on energy efficiency. The cost of new and expanded end-use efficiency programs is going to be even more substantial in the future. In accordance with AB 2021 as adopted by the Legislature in 2006, the SCPPA members will, in procuring energy, first acquire all available energy efficiency and demand reduction resources that are cost effective, reliable, and feasible. Cal. Pub. Util. Code § 9615.

B. Renewable Resource Costs.

In addition to vigorously pursuing energy efficiency and demand reduction measures, the SCPPA members are aggressively adding renewable resources. The SCPPA members committed themselves in 2003 to achieving a 20 percent renewable portfolio standard by 2017. Individual SCPPA members are now adopting more aggressive timetables. For example, on June 5, 2007, the Burbank City Council increased the City's commitment to 33 percent by 2020. Riverside is in the process of adopting the same commitment.

SCPPA is currently procuring roughly 500 MW of wind energy, 200 MW of geothermal energy, 100 MW of solar-thermal energy, and 30 MW of biomass-based energy. The cost is projected to be approximately $267 million per year. SCPPA is also investigating an integrated

solar thermal system to displace coal use at San Juan Project in New Mexico. Individual SCPPA members are pursuing their own renewable projects apart from SCPPA.

Consistent with the SCPPA members' commitment to adding renewable resources, SCPPA is undertaking substantial transmission projects in order to bring renewable energy to load centers in southern California. The Greenpath North Transmission Project, a 1,200 MW transmission line from the Imperial Valley to Los Angeles, is being designed to import geothermal energy. The Southern Transmission System upgrade would add 480 MW of capacity from Utah to Los Angeles to import wind energy. The Greenpath transmission line is projected to cost more than $335 million plus financing costs. The Southern Transmission System upgrade is projected to cost $90 million plus financing costs.

SCPPA is also undertaking research and development efforts. The primary effort is aimed at reducing or eliminating the GHG impact of carboniferous resources through carbon sequestration.

C. Cost Impact.

In addition to the direct costs of energy efficiency and renewable energy programs, there is a correlative cost of stranded investment that results from undertaking the programs. Most SCPPA members are fully resourced with owned generation and long-term power purchase contracts. Many members project a two percent or less growth rate. The consequence of reducing load through energy efficiency programs or replacing carboniferous generation with renewable generation will be reduced usage of existing resources. That will result in a stranded cost of underutilized resources that the SCPPA members and their ratepayers will, nevertheless, be required to bear.

With no relief from the burden of stranded costs, the cost of expanded energy efficiency programs, the cost of new low carbon and non-carboniferous resources, and the cost of related

transmission capacity that will be needed to meet AB 32 goals are projected to increase rates by as much as 30-50 percent for some SCPPA members.

V. REQUIRING SCPPA MEMBERS TO BEAR THE COST OF REDUCING THEIR RELIANCE ON CARBONIFEROUS RESOURCES *PLUS* THE COST OF ACQUIRING ALLOWANCES THROUGH AN AUCTION WOULD RESULT IN AN INEQUITABLE WEALTH TRANSFER.

It would be punitive to require SCPPA and its members to bear *both* the massive cost of shifting from their historical reliance carboniferous resources *and* the cost of acquiring allowances through an auction. Assuming an annual cost of $25 CO_2/ton, SCPPA members would have to expend nearly $600 million annually to buy emission allowances. The cost of emission allowances would increase rates by 25-30 percent for some SCPPA members. On average for all members, rates would increase 10-20 percent. These allowance-driven rate increases would be *additional* to the rate increases that will be needed to pay for new and expanded energy efficiency programs, new low carbon and non-carboniferous resources, and associated transmission capacity that will be needed for the SCPPA members to meet GHG reduction goals.

The consequence of requiring the SCPPA communities to spend hundreds of millions of dollars for auctioned allowances would result in a wealth transfer from the SCPPA communities to others in the state. Under the program envisioned by the MAC, the money spent for allowances would be reallocated without regard to who contributed the money. The MAC proposes that auction proceeds be "directed to investments in end use efficiency improvements and technology R&D" and "to keep the net cost of electricity to consumers from rising too far in the early stages of the program." DR at 51, 75. Some other potential uses of auction proceeds are the following:

- Promote investment in low-GHG programs
- Promote end-use efficiency
- Increase assistance to low-income consumers
- Displace income taxes or other taxes that distort economic decisions
- Finance reductions of GHGs and criteria pollutants in communities that bear disproportionate environmental and public-health burdens
- Promote investments that will help the state's ecosystems and citizens adapt to the impacts of global warming
- Provide transition assistance aimed at mitigating the impact a pollution cap might have on workers or firms that are subject to strong market pressures from competitors located in un-capped jurisdictions
- Provide broad-based compensation through tax-shifting.

DR at 53-54. Using auction proceeds for these purposes might result in LSEs that are more reliant on carboniferous resources getting back some of the money they pay for auctioned allowances, but there would be no necessary correlation between money spent and money returned. Most likely, given the array of envisioned uses for auction proceeds, LSEs that are more reliant on carboniferous resources would get back less—possibly much less—than what they pay for auctioned allowances. The difference would constitute a wealth transfer to others, including LSEs that are less reliant on carboniferous resources.

A wealth transfer from the communities that are most challenged to phase out their reliance on carbon-based resources to those that are less challenged would be unfair, inequitable, and unnecessarily punitive. Imposing the cost of auctioned allowances on top of the cost of GHG reduction measures could produce rate shock that would undermine public acceptance of

GHG reduction goals regardless of how wholeheartedly SCPPA and its members embrace achievement of those goals.

VI. FREE ALLOWANCES BASED ON *HISTORICAL EMISSIONS* FOR LSES ARE NECESSARY TO PREVENT AN UNJUSTIFIABLE WEALTH TRANSFER.

Free allowances to LSEs are a first step to preventing unjustifiable inter-LSE wealth transfers. Accordingly, SCPPA is pleased that the MAC recognizes that "several factors weigh in favor of distributing some allowances for free at the outset of the program …." DR at 52. While "there should be no free allocation to firms under the cap that are able to pass most of their costs on to consumers," the MAC recognizes that LSEs are different: "LSEs that are closely regulated or municipally-owned are not included, since these entities are likely to be obligated to pass a freely allocated allowances through to their ratepayers." DR at 53.

However, more than free allowances to LSEs are needed to prevent inequitable wealth transfers. The free allowances to LSEs must be allocated on the basis of *historical emissions*, with the amount of allowances that are made available on the basis of historical emissions being ramped down to reflect a progression through successive compliance periods toward attainment of the 2020 GHG reduction goal.

If free allowances were allocated among LSEs on any basis other than historical emissions, LSEs would receive allowances that were inevitably disproportionate to their emissions. That would expose LSEs to wealth transfers. For example, if free allowances were allocated among LSEs on the basis of load, higher-emission LSEs would most likely receive fewer allowances than they need. Low-emission LSEs would receive more than they need. The higher emission LSEs would probably be required buy auctioned allowances, which would result in a wealth transfer to recipients of the auction proceeds including the low-emission LSEs. The higher emission LSEs may also need to buy allowances directly from others including the

low-emission LSEs through the cap-and-trade secondary market. That would result in a direct wealth transfer from the higher emission LSEs to the allowance sellers.

Allocating free allowances on the basis of load would not only result in inequitable wealth transfers. It would contradict the MAC's statements about the importance of fostering end-use efficiency. DR at 51, 53, 75. Allocating free allowances on the basis of load would weaken the incentive of LSEs to pursue energy efficiency aggressively, insofar as any decline in load would result in a decline in carbon allowances. By contrast, allocating free allowances among LSEs on the basis of historical emissions with the allocations declining over time to reach the AB 32 target for 2020 would provide every LSE with a strong motivation to pursue energy efficiency programs. Insofar as the amount of allowances received by each LSE would be independent of their future year energy loads, every LSE would have a strong incentive to constrain their carbon emissions to match their allocation of allowances.

An alternative to providing LSEs with allowances based on historical emissions would be to require LSEs to acquire allowances through an auction but to refund the amount each LSE pays on a dollar-for-dollar basis. However, this would be an undue complication that would be inconsistent with the MAC's fundamental objective of simplicity. DR at 18. Also, requiring LSEs to buy their allowances through an auction with the promise of a refund could result in a "diversion of allowance value" which could thwart the refund. DR at 54.

Allocating free allowances to LSEs on the basis of historical emissions with a gradual ramp-down would be consistent with previous emissions containment programs, including both the SO_2 Acid Rain Trading Program and the Southern California Regional Clean Air Incentives Market ("RECLAIM"). DR at 89-90; 92.

VII. CONCLUSION.

SCPPA urges the MAC to revise the DR to recognize that, as the result of historical and geographical circumstances, the resource mix of some LSEs is dramatically more carbon-intensive than the mix of others, and that a likely consequence of this asymmetry would be a massive wealth transfer if LSEs were required to participate in an auction for emission allowances.

SCPPA urges the MAC to revise its statements of fundamental objectives, Guiding Design Principles for a cap-and-trade program, and the principles for distributing free allowances in the manner set forth above to preclude inequitable wealth transfers from communities that are more challenged or face proportionally greater costs in reducing their carbon footprint due to historical or geographic circumstances.

SCPPA urges the MAC to include a passage in its final Recommendations to recognize that in order to preclude unfair wealth transfers, LSEs should be allocated free allowances on the basis of historical emissions with the allocation ramping down gradually to meet the AB 32 goals for 2020.

Respectfully submitted,

Norman A. Pedersen, Esq.
HANNA AND MORTON LLP
444 South Flower Street, Suite 1500
Los Angeles, California 90071-2916
Telephone: (213) 430-2510
Facsimile: (213) 623-3379
E-mail: *npedersen@hanmor.com*

Attorney for the **SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY**

Dated: June 11, 2007